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OVO's response to the Ofgem call for input: Locational Pricing Assessment

Summary

Having already been involved in the discussions to date on the issue, OVO welcomes the opportunity to respond to Ofgem's call for input that will inform its Locational Pricing Assessment.

While we manage the impact of surging wholesale prices on customers' energy bills, it is right to consider the longer-term reforms and electricity market arrangements that are needed to deliver the transition to net zero at an affordable price for households. Locational pricing has the potential to support this aim by ensuring that the electricity system decarbonises at least cost. A shift to more accurate, cost-reflective pricing will ensure the right infrastructure is built in the right places, supported by operational decisions that maximise the benefits of a flexible, low-carbon energy system.

We support Ofgem's work to explore how locational pricing might play a role in delivering on these objectives. It will be important that the regulator understands the impact of moving to locational pricing alongside other potential reforms to the energy market, including the evolution of market-based support schemes for renewable power generation, changes to the distribution of policy costs levied on electricity and gas bills, and future decisions on the role of gas for domestic heat.

It is imperative that any changes put consumers first, with a focus on delivering low-cost energy, and creating opportunities to engage with the value of flexible energy systems that can help reduce household energy bills and carbon emissions. In particular, vulnerable customers, and those unable to respond to new pricing signals, should be supported in a way that avoids them being penalised. Distinctions will need to be made between those customers who are unable to respond, and those who are not yet engaged sufficiently to respond to pricing signals. For the latter group, energy retailers will have an important role to play in encouraging engagement and interaction with flexibility services. This means that any move to locational pricing should be developed in partnership with the sector to ensure a market framework is developed that delivers for customers and the country's decarbonisation goals.

The key opportunities associated with introducing more granular locational pricing in GB

Locational pricing has the potential to reduce energy costs for consumers by ensuring that generation, flexibility and grid investment becomes more efficient. In recent years, the costs of balancing the energy system and investing in energy network capacity to facilitate the evolving generation mix and changing demand patterns have grown significantly. Locational pricing has the potential to help reduce these costs, thereby lowering energy bills for most consumers. But implementation is key to ensure that an efficient energy system is the final outcome.

OVO considers that flexibility is key to delivering a low-cost transition to net zero. Locational pricing could help ensure that flexibility solutions are better able to compete with traditional generation in cases where they are the cheapest option for solving regional constraints, and for ensuring that delays and high costs of grid investment do not prevent low-carbon generation from coming onto the system.

Decisions will need to be made on how exposed domestic consumers are to these price signals. There is an opportunity for locational pricing to be used to create clear financial incentives for households that respond to energy constraints or oversupply, but this comes with risks and necessary mitigations, which are highlighted below. Locational pricing could also be implemented in a way that shields consumers from sub-national price signals, however, this could be a missed opportunity if other flexibility market measures fail to deliver the same effect.

The key implementation challenges, risks and mitigations

Locational pricing will introduce new complexities to energy markets, and this will need to be carefully managed. As highlighted above, we consider that one of the main risks from a move to some form of locational pricing is the potential negative impacts for households that are not able to respond to pricing signals and opportunities for financial benefits that will come from flexibility markets. If managed poorly, this could create a double negative impact - a loss of opportunity to save money, and the potential to face higher costs. This is likely to happen if customers are not adequately supported in making energy use changes, or do not receive mitigation in response to limitations on their opportunities to respond.

Additional complexity would pose a particular risk to vulnerable customers, who are often less able to engage with the energy retail market, or who have particular energy needs. As such, Ofgem will need to carefully consider and design measures to protect these customers from additional costs and complexity.

Across the consumer-base more broadly, Ofgem will also need to ensure that locational pricing does not discourage engagement with retail energy markets by creating excess complexity, e.g. by making it harder for households to predict their energy costs or making it harder for consumers to compare and understand different electricity tariffs.

These changes will need to be aligned with the management of energy use data, supported by the smart meter programme and visibility of network and system-side system data. Regulatory programmes that are encouraging better use and collection of data will need to be aligned with any locational pricing reforms.

The proposed approach to modelling zonal and nodal market designs

We are aware of a variety of potential approaches to modelling the system and price impacts of different zonal and nodal market designs.

Ofgem's analysis needs to consider the wide range of consumer impacts associated with locational pricing. Ofgem must also take account of hard-to-monetise benefits and ensure that its evaluation process properly accounts for risks associated with reforms. For example, Ofgem's analysis should account for the risks to consumers' confidence in investing in new heating systems, energy storage and other low-carbon technologies. Any assessment of the design options should consider how they support the UK's decarbonisation targets, including delivery of key technology targets, such as the deployment of heat pumps.

Next steps

We fully support the work that Ofgem is progressing in this important area. Given the considerable consumer orientated opportunities and risks we are keen to be closely involved and look forward to supporting Ofgem as the process progresses.